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Convergence of Corporate Governance Models: The Arguments in Favor and Against its Possibility

Hassan Ahmed SHIRWA
Yeditepe University, MBA Student
shahmed114@gmail.com
ORCID: 0000-0002-5018-7243

Assist. Prof. Dr. Murat ONUK
Yeditepe University, Business Administration
murat.onuk@yeditepe.edu.tr
ORCID: 0000-0002-9737-7386

Abstract

The purpose of this paper is to explain and analyze both the arguments which support and the arguments which are against the possibility of convergence among corporate governance models. Two types of corporate governance models are widely used in the world. These two types are: Shareholder model and stakeholder model. The former one is mainly characterized with dispersed ownership whereas the later one is characterized with concentrated ownership. For the past two decades, corporate governance researchers have argued about the convergence possibility and this debate mainly divided them into two groups: A group that supported this possibility by arguing that financial market competition and the increasing similarity of financial markets due to the globalization will lead to corporate governance convergence especially towards shareholder model. The other group argued that as long as there are legal, institutional, culture and political differences, it is unlikely to achieve convergence. After analyzing both arguments for and against convergence, the study found that it is hard to harmonize the differences between countries such as legal, culture, and political issues in order to achieve convergence. So, it is unlikely we see corporations around the world adopt the same model of corporate governance.

Keywords: Corporate Governance, Convergence, Shareholder Model, Stakeholder Model.

1. Introduction

Corporate governance can be defined as the institutions that affect the way business companies administer resources and returns. This definition also included the laws or rules by which corporations are operated, administered and monitored (O'Sullivan, 2000). Different countries in the world follow a corporate governance model which is based on the country's legal framework, financial model, history and culture. It is possible to categorize these corporate governance systems under two major models: shareholder and stakeholder models.

These two models represent two types of share ownerships: dispersed ownership of shares represented by the shareholder model used prominently in the Anglo-American countries[1] and concentrated ownership of shares represented by the stakeholder model which is used in continental Europe and also in Japan (Palmer, 2011).

[1] Used in the USA, UK, Australia, Canada, New Zealand and several other countries.

When convergence debate between the models came out, the shareholder model was dominant because of the USA dominance in the world after World War II. This was when proponents of convergence, especially convergence to the shareholder model, started thinking that it was time for the world to converge to this model. But according to Guillen (1999), after Germany and Japan emerged as big power manufacturing countries, the idea of converging towards the US model took a step back.

Researchers have different views on why we have convergence debate for such a long time. Some of them argue that convergence came out as a result of competition that prioritize corporate governance model which produces upper stages of economic effectiveness; whereas others argue that convergence is a result of the increasing political domination of the USA's financial interests (O'Sullivan, 2003).

Both convergence proponents and opponents have their arguments, but one main argument for convergence supporters is globalization of markets, which they mean that eventually markets are going to converge towards one model especially towards the shareholder model. On the other side, convergence opponents have many evidences to support their argument. They put forward the factor of differentiation of cultures, in which they argue that to bring together two different cultures under one corporate governance model is impossible, thus convergence theory is impossible.

This paper tries to explain and analyze the arguments in favor of and against convergence. The paper begins with a comparison between the two models of corporate governance. Section 3 describes convergence whereas section 4 and 5 analyzes the arguments of both convergence supporters and opponents respectively. finally, section 6 concludes the paper.

2. Corporate Governance Models

2.1 Shareholder Model

According to Mathur (2016), the shareholder model is known for having share ownership mostly owned by investors (called outside shareholders). Their responsibility, is to choose the directors and then the directors will choose the managers of the company, and in this way the division of ownership and regulation will be maintained. The countries which use shareholder model, their legal structure defines the right of shareholders to regulate the corporation and makes the board and management clearly responsible to shareholders (La Porta et al., 1997).

The legal system was based on the suggestion that dispersed investors hold the shares of the corporation, that they act independent from each other and that they require trustable and enough information flows so as they can make investment decisions. Control has always been based to give relatively enough knowledge to investors and to establish relative equality between investors on the access to information (Nestor & Thompson, 2000).

In this system, there is one stakeholder that has a significant effect on managerial decision-making: the shareholders. The corporations are seen as a mixture of managerial directors performing for the interest of shareowners or as a method for the establishing shareholder profit. A single-tier board of directors is also known with this system where executive and supervisory duties are combined in one legal organ (Weimer & Pape, 1999).

2.2 Stakeholder Model

Stakeholder model is a contemporary evolution keeping in requirements with today's business dynamics. This model has come out as an enormous model with shareowners seen as one among the different stakeholders influenced by the performance of the companies. The underlying feature of stakeholder model is to increase human welfare in which way it might be (Bhasa, 2004).

This model is known for considering the interests of all the stakeholder groups and not only just the interests of shareholders. The main countries which use this model are Germany and Japan. According to Moerland (1995), Corporations in Germany are not regarded as a way to increase

shareholder value as it is the case in the Anglo-American countries. Instead, they are considered as a sovereign economic entity consisting of different groups such as; management, shareowners, employees and suppliers. A general comparison between these two models can be shown in Table 1

Table 1: Characteristics of shareholder and stakeholder corporate governance systems

Stakeholder	Shareholder
Companies owned mainly by insider shareholders who also have control over management	Large companies controlled by managers but owned mainly by outside shareholders
System is known by little separation of ownership & control such that agency problems are rare	System is known by separation of ownership & control which creates significant agency problems
Hostile takeover exercises are rare	Frequent hostile takeovers acting as a disciplining mechanism on company management
Concentration of ownership in a small group of shareholders including founding family members, other companies through pyramidal structures, state ownership	Dispersed ownership
Excessive regulation by a small group of 'insider' shareholders	Moderate regulation by a large range of shareholders
Wealth transfer from minority shareholders to majority shareholders	No transfer of wealth from minority shareholders to majority shareholders
Weak investor protection in corporation law	Strong investor protection in corporation law
Potential for abuse of power by majority shareholders	Potential for shareholder democracy
Majority shareholders incline to have more voice in their investee companies	Shareholding characterized more by exit than by voice

Source: Solomon and Solomon 2004 (p.151)

3. Convergence in Corporate Governance

According to Yoshikawa and Rasheed (2009), any discussion about convergence is not complete unless we are able to define what the entities in a given group are converging towards. To clarify this, a statement that Japanese and American governance is converging could mean a number of different things. First, it could mean that American governance practices are becoming more like Japanese practice. Second, it could mean that Japanese governance is becoming more like American governance. Third, it could mean that both are converging towards the midpoint between them. Finally, it could also mean that both systems are moving towards some kind of a normative ideal that is very different from their current positions.

The debate on a single corporate governance system brought about various pros and cons, being unlikely to achieve a certain compromise. The pros generally rely upon the view that harmonized practices in terms of employment, production and marketing provide incentive to a highly competitive environment. The cons support the idea of the impossibility to harmonize different

corporate governance because of intrinsic diverse characteristics emerging due to various legal structures or financial markets (Al Essawi & Brezeanu, 2011).

The argument which supports the idea of convergence especially towards the Anglo-American model was suggested by Henry Hansmann and Reinier Kraakman (Hansmann & Kraakman, 2002). They argued that the victory of Anglo-American model was already assured and it was time for other countries to adopt this model. The base of their argument was that the Anglo-American system out-competed the rival corporate governance models during the post-Second World War.

The opposing argument argued that there is no possibility of corporate governance models converging towards unified system. The base of their argument is the differences between the countries, such as the political, economic, legal and cultural differences. So, according to the proponents of this arguments, there will not be a convergence as long as these differences are there.

4. Arguments in Favor of Convergence

4.1 The Failure of Alternative Models

Hansmann and Kraakman (2002) argued that the convergence of corporate governance already occurred and it was toward the shareholder model. They argued that this model triumphed over the other model at the time which were manager-oriented, labor-oriented and state-oriented models. Although these models achieved some success in their time, all of them have ultimately lost their normative appeal.

4.2 Competitive Pressures Toward Convergence

According to Hansmann and Kraakman (2002), the shareholder-oriented model has emerged as the normative consensus not just because of the failure of the alternative model, but because important economic forces have made the virtues of that model increasingly prominent. There are three ways in which a model of corporate governance can come to be recognized as superior: by force of logic, by force of example, and by a force of competition.

4.3 Globalization of Financial Markets

The growing integration of financial markets is a key factor of convergence of corporate governance systems. Investors in most countries increasingly accept the proposition that holding an international equity portfolio leads to higher returns and lower risk than a purely domestic portfolio. As a result, many pension funds now allocate a certain portion of their portfolios to international equities while a large number of specialized mutual funds have been developed to allow individuals to participate in foreign equity investment. As of now, this phenomenon of international diversification is mostly visible in countries which already have strong institutional investor communities, but as other countries succeed in developing institutional saving, one would expect it to be generalized (Nestor & Thompson, 2000).

According to Jacoby (2001), multiple foreign corporations listed their corporations on the USA exchanges. To fulfill exchange requirements, the corporations had to adopt USA standards such as having at least two outside directors and giving equal opportunity for all shareholders to participate in tender offers.

The conditions that led to the globalization of financial markets differ according to countries, but according to Jeffers (2005), free circulation of capital has become common place. He also argued that this globalization has been accompanied by a certain number of structural changes. In this sense, investment management has become far more professionalized.

Finally, financial market rivalry globally and its effect in the world finance are probably the reasons to expect convergence and increase in information collection. Therefore, producing larger data or facts revelation. As a result, this will cause to decreased effect of banks and the idea of unification of corporate governance models towards shareholder model (Perotti & Von Thadden, 2003).

4.4 Diffusion of Codes of Good Governance and Harmonization of Accounting Rules

Aguilera and Cuervo-Cazurra (2004) analyzed this issue and found that countries with weak shareholder protection, high government liberalization, and a strong presence of foreign institutional investors tend to develop good codes of governance.

One of the major problems that a firm faces when it decides to list in a foreign exchange is the need to restate its accounts following the standards prevailing in that country. Similarly, investors interested in making portfolio investments in other countries face the problem of understanding the accounting practices followed in that country. Clearly, the prevalence of different accounting standards is an impediment to capital flows across countries. This problem is currently being addressed by the development of a core set of international accounting standards by the International Accounting Standards Committee (Yoshikawa & Rasheed, 2009).

5. Arguments Against Convergence

5.1 Theory of Path Dependence

In contrast to the above arguments, Bebchuk and Roe (1999) introduced path dependency theory. This theory highlights on why the developed economies, in spite of the pressures to converge, differ in their ownership patterns. It also gives a basis on why some significant differences might still be there. They shed light on two sources of path dependency theory: structure driven and rule driven path dependencies.

The former one describes the direct influence of initial ownership frameworks on subsequent ownership frameworks. The later one is the result of primary ownership structures effect on subsequent structures through their influence on the legal rules governing companies. In addition to this, they argued that existing corporate governance structures might well be there because of internal rent-seeking, even if they stop being efficient. Furthermore, they identified reason for each of structure path and rule path dependency theories. For example; structural path dependence is grounded in efficiency and in rent seeking, whereas rule driven path dependence is grounded in efficiency and in interest group politics.

Jeffers (2005) argued that each country's path will eventually affect the convergence outcome. He argued that the development of corporate governance systems will be different and progressive by looking each country. However, the system which countries will converge will rely on its initial point, and the outcome will vary looking if the first system at the starting point was shareholder or stakeholder.

5.2 Legal Argument Against Convergence

The legal argument against convergence in corporate governance notes that corporate law is intimately related not only to social custom but also to other legal areas, such as banking, labor, tax, and competition law, that would be exceedingly hard to change all at once because of the various interests created around them (Guillen, 1999).

5.3 Political Argument Against Convergence

Given the differences in the political perspectives of nations it is difficult for any nation to quickly adapt to foreign best practices. Some economies are in better positions to agglomerate capital due to their political presence internationally and also because of their internal structures of governance that are so well defined that spreading risk becomes easier to them. Liquid capital markets coupled with strong institutional investors design and redefine corporate best practices through their monitoring and control roles (Bhasa, 2004). Overall, political differences can be as a main barrier to the convergence topic since countries are not willing to give up their political interests in favor of convergence.

Proponents of a convergence in corporate governance models and practices tend to forget that such worldwide trends as economic and financial globalization are not only fragmented and contradictory but also shaped and contested by political interests. The literature on the diffusion of corporate governance and organizational forms in general is replete with detailed studies of how domestic political conditions affect outcomes. Domestic politics mediate in the relationship between external trends or shocks and outcomes (Guillen, 1999).

5.4 Differentiation of Culture and Tradition

Corporate governance is the field linked with all welfare of employees, board of directors and managers of the corporation. Removing the conflict of interests among the people is the main aim of this governance system. The idea of convergence is an idea given by scholars but they forgot to see the differentiations in cultures, laws, traditions and society. Therefore, it becomes difficult to predict that whether convergence can be possible or not (Mathur, 2016).

Culture of the societies shapes the rules and institutions in which they operate. Culture can be defined as the socially conveyed behavior ways, attitudes, values and norms of a specific society. So, although the USA and Europe share many values and beliefs, they also differ to the significance regarding to two important cultural values: individualism and communitarianism (Salacuse, 2003).

6. Conclusion

The possibility of convergence between these two models has been debated in the literature. In this paper, we have analyzed two arguments: one that supports convergence whereas the other one was against. Proponents of convergence argued that It is likely that corporate governance will converge due to the globalization. They also suggested that this convergence will be toward the shareholder model since this model is the best of the two models.

The counter argument argued that It is unlikely that corporate governance models will converge. They suggested to leave the situation like it is, meaning to let the countries use their own models. Opponents of convergence argued that it is unlikely to unify these models due to the historical, cultural and legal differences between the countries.

To achieve convergence of the two different models of corporate governance followed in these countries will need to arrange their systems according to the converging model and this will be hard to do at once because of the conditions which were built upon them. Bebchuk and Roe (1999) argued that the reason why countries differ, despite the all the pressures to converge, can be explained by the path dependence theory. With this theory, Bebchuk and Roe suggested that countries differ with their initial conditions, that means the original ownership frameworks of corporations decides the ownership in the future. So, as long as these differences exist, they argued, convergence is unlikely to occur.

Finally, this paper is against convergence and the reason is the difference among the countries such as the economic, legal, culture and political frameworks. So, it will still be impossible to achieve convergence unless countries change all the barriers of convergence. This unfortunately looks very difficult. The result is that each country will continue to adopt its style according to their needs.

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